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ROUTING AND RECORD SHEET

82 - 2146/1

SUBJECT: (Optional)

Meeting of Cabinet Council on Economic Affairs

FROM:	EXTENSION	NO.
Maurice C. Ernst NIO/Economics		DATE 21 January 1982

STAT

TO: (Officer designation, room number, and building)	DATE RECEIVED	DATE FORWARDED	OFFICER'S INITIALS	COMMENTS (Number each comment to show from whom to whom. Draw a line across column after each comment.)
1. C/NIC		1/21	HSR	
2. ~~DSC~~ DDCI	1/22	1/22		
3. DCI	Rec'd 22 Jan 82	1/22 C		
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82-2163

THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

DDI #510-82
21 January 1982

National Intelligence Council

MEMORANDUM FOR: Director of Central Intelligence

VIA: Chairman, National Intelligence Council

FROM: Maurice C. Ernst
National Intelligence Officer for Economics

SUBJECT: Meeting of Cabinet Council on Economic Affairs

1. On 21 January I attended a meeting of the Cabinet Council on Economic Affairs at which two topics were discussed: (1) The degree of support of US international economic policies from our foreign friends; and (2) The US economic situation.

2. On the international topic, Beryl Sprinkel of Treasury noted substantial support in Europe for most US policies concerning the IMF and the World Bank. He also noted strong criticism of what our foreign friends perceive as excessively expansionary fiscal policies coupled with excessively tight and erratic monetary policies, leading to high interest rates. The Europeans and Japanese, moreover, are less tolerant of sharp interest rate and exchange rate fluctuations and would prefer more US government intervention in both markets.

3. On domestic economic issues, Larry Kudlow of OMB gave a trenchant presentation on what is making the financial markets pessimistic and on the high risk of an aborted economic recovery if projected budget deficits are not reduced (see attached briefing outline).

Maurice C. Ernst

Attachment,
As stated

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DDI #510-82
21 January 1982

SUBJECT: Meeting of Cabinet Council on Economic Affairs

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January 21, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Lawrence A. Kudlow

SUBJECT: Financial and Economic Update (Executive Summary)

1) Once again, interest rates are on the rise. After a euphoric period during September, October and November, when interest rates across-the-board fell substantially, the sharp run-up in rates during the past seven weeks represents a major financial market setback.

   - o From late August until late November, 3-month T-bill rates declined by 550 basis points (15.7% to 10.2%), 3-month commercial paper by 630 basis points (17.2% to 11.1%), and 3-month CD's dropped by 670 basis points (18.2% to 11.5%). The prime rate declined from 20.5% to 15.7%.

   - o In October and November, long-term rates also fell sharply. 30-year Government bond yields dropped from 15.1% to 13.0%, while new AAA utility bonds moved from 17.7% to 14.7%. The FHA mortgage rate also edged lower, from 18.3% to 16.0%.

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- o Since late November, however, credit conditions have abruptly tightened.
  - -- 3-month Treasury bills have moved back to 12%
  - -- 3-month commercial paper has increased to 12.7%
  - -- 30-year Treasury bond yields are back to 14.4%
  - -- AAA utilities are nearly 17%

2) Have we seen the cyclical bottom in rates? Interest rate movements are always irregular, but a recessionary trend line typically finds rates falling for about 12-18 months. Yet even with a good sized bond rally during the winter quarter, it may be difficult to get yields back to their late November lows.

- o At 13% for government bonds, and 14 3/4% for high grade utilities this would be the highest cyclical trough in history.
- o The cyclical trough for T-bonds was about 7% in 1976 and about 10% in 1980.
- o Futures markets shows only a small decline in T-bond rates during the next 2 years, while T-bill rates by year-end 1983 are projected to be around 14%.

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- o If these market forecasts turn out right, last November's rates would not only be the highest trough on record, but until recently would have represented historic highs for interest rate peaks.

3) But the inflation rates continue to fall. Yet even a major reduction in the rate of inflation has not been able to put interest rates on a sustainable downward course.

- o On an annual average basis, 1981 registered the first downturn in inflation since 1976.

Annual Inflation Rates

	CPI	PPI	GNP Deflator
1977	6.5	6.5	5.8
1978	7.7	7.8	7.3
1979	11.2	11.1	8.5
1980	13.5	13.5	9.0
1981	9.5(e)	7.0(e)	8.7(e)

- o When measured over 3 month periods, the CPI has fallen from 13.5% last September to 8.4% in November and the PPI has dropped from double digit growth last spring to a remarkable 5.4% through December.

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4) Yet interest rates are sending a different message. It is the financial markets' fear about prospective events. Interest rates are best viewed as a proxy for expectations of the future. And the credit markets are worried that present fiscal and monetary policies may not produce lower inflation in the future.

- o On the fiscal side, given the latest information available to the market (the December 2 Troika economic and deficit numbers), there is great concern of Federal deficits and borrowing and overall credit demand.
  - -- Budget outlay estimates for the 1982-84 period have risen substantially since the original fiscal plan was unveiled in February 1981. The 1983 estimate has increased by $65.7 billion, or 9.0%, while the 1984 estimate has growth by $73.1 billion, or 9.5%. This budget drift is similar to outlay adjustments during the previous 4 years.
  - -- The last information on deficits (Dec 2 Troika) suggests that the recovery cycle over the 1982-87 period will generate a deficit/GNP path which averages 2.1%, nearly the same as the 2.4% of the 1975-81 recovery period, and twice the average 1.2% ratio which has characterized all post World War II recovery periods.
  - -- In late November the pledge to balance the budget by 1984 was formally removed from Presidential policy. To many observers this suggested a removal of reliable and credible budget discipline.

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- On the monetary side, there has been an unexpected and counterproductive surge in money growth during the past two months.
  - -- After declining at a 0.5% annual rate from May to November, M1B growth suddenly has surged to 14.3% over the past two months.
  - -- This money growth has been based on a 10.6% annual rate of increase for total reserves, and a 16.9% rate for nonborrowed reserves. The growth of these reserve aggregates suggests that the money growth of the past 2 months is no technical fluke, but instead is rooted in a significant Fed policy shift.

- Thus, with respect to fiscal and monetary policy, from the market's perspective present actions suggest that the future looks much like the recent past.
  - -- Heavy Federal spending and borrowing, absorption of capital and preemption of private investment
  - -- Excess money growth and reawakening of inflationary pressures
  - -- Future damage to investment, inflation and economic growth.

- And there is one matter on which everyone can agree: the recent past has not been good.

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5) But on the brighter side, the economy may now be in a turning zone, and growth in the first half of 1982 may exceed concensus expectations.

- o Prices of commodity futures, particularly metals and industrials reached bottom in November and exhibited some moderate strength in December and early January.

- o The stock market reached bottom in September, and has shown erratic strength since then. The Dow Jones' low was 807 in late summer, and since then has averaged around 850. This does not suggest a strong recovery, but neither does it indicate a deeper recession.

- o Certain key stock market groupings have reached bottom and have rebounded somewhat since September: home furnishings by 15%, railroads by 15%, paper containers by 13%, consumer goods by 4%. Autos, however, have not indicated any recovery.

- o After declining 40% during the first 9 months of 1981, single family home sales ticked up 14% in October and another 11% in November.

- o Privately owned housing starts rose 13% in December, to a level of 978,000. The November level was 863,000. From January to November, housing starts fell by a whopping 48%.

- o New housing permits rose 12% in December after a 40% cumulative decline during the first 11 months of 1981.

- o Real consumer spending rose by 3.8% in November and 4.1% in December, after major reductions in previous months.

- o Money growth during the past 3 months has grown by 10 1/2%, a leading indicator of more rapid growth in income, sales and final demand.

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6) Looking up from the bottom: Is sustainable recovery possible?

- o Money growth and tax reduction suggest that economic recovery may come sooner rather than later.
  - -- Real growth in Q1/82 may be about flat
  - -- But it could represent a turning zone situation, leading to much stronger growth in Q2/82.
- o But there are forces which suggest that the second half of 1982 may be much more sluggish than expected
  - -- At current interest rate levels, the financial situation is as fragile as ever
  - -- Business firms have not been able to properly reliquify their balance sheets, due in large part to prohibitively high bond rates
  - -- Private credit demand is likely to remain relatively strong
  - -- Excessive Federal and federally-assisted borrowing will compete with private credit demands, absorbing much needed capital resources and generating additional upward interest rate pressures as the year continues.
  - -- Monetary trends are uncertain: with heavy Federal and private borrowing, can the Fed stay firm in its monetary control and anti-inflation resolve?

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- The heavy credit demand/high interest rate/sluggish recovery scenaro may not actually take place, but right now this seems to be the best guess of investors.

- To reverse this pessimism fiscal initiatives must credibly reduce spending and borrowing, while monetary growth must be kept moderate.

- Then perhaps 1982 will turn out to be a better year. But right now market attitudes are not encouraging.

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